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SIPDIS
SENSITIVE

DEPT FOR EAP/MTS, EAP/EP AND EEB/IFD/OMA
TREASURY FOR IA/MALACHY NUGENT AND TRINA RAND
COMMERCE FOR 4430/KELLY
DEPT PASS FEDERAL RESERVE SAN FRANCISCO FOR CURRAN
DEPARTMENT PASS EXIM BANK
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
USDA/FAS/OGA CHAUDRY, DWYER
DEPT PASS USTR WEISEL, EHLERS

E.O. 12598: N/A
TAGS: EFIN EINV ECON EAGR ID
SUBJECT: COMMODITY PRICE COLLAPSE UNDERMINES GROWTH AMID ONGOING
TURMOIL

¶1. (SBU) Summary: The global financial crisis, slower global growth, and falling commodity prices continue to weigh heavily on Indonesian financial markets. The sharp decline in world prices for Indonesia primary commodity exports clouds the already diminished outlook for economic growth over the next twelve months and adds additional pressure on the Indonesian Rupiah (IDR). The negative commodity price shock also threatens to weaken the banking system, given rapid expansion of lending to commodity-based sectors in recent years. Food prices, which have seriously strained Indonesian household budgets this year, have not fallen significantly in Indonesia, limiting the potential positive impact of lower world prices on Indonesian households. Analysts worry that growing political pressure to ease monetary policy and lower subsidized fuel prices will further undermine investor confidence, putting pressure on the IDR and destabilizing prices. End Summary.

Financial Market Turmoil Continues

¶2. (SBU) The global financial crisis, global growth, and falling commodity prices continue to weigh heavily on Indonesian financial markets. The Indonesian stock market fell an additional 4.7% on October 28, bringing the decline in value since its peak in January 2008 to over 60%. The yields on 10-year government bonds continued to rise rapidly on October 27, jumping over 400 basis points in one day to 20.9%. The one-month Jakarta interbank lending rates also continued to move upward, rising to 11.5% this week, up from 9.5% in July. Market analysts attribute much of the recent volatility to Indonesia's thin capital markets and open capital account, which allows investors to move money quickly out of Rupiah-based assets.

¶3. (SBU) The IDR has also depreciated sharply, crossing the IDR/USD 12,000 mark during trading on October 28. As of October 29, the IDR has lost almost 18% yoy of its value, despite active intervention by the central bank. Bank Indonesia's (BI) official reserves fell by $4.1 billion during the first 15 days of October, suggesting that BI's over $50 billion in foreign currency reserves may be insufficient to fight further depreciation. To date, analysts have

attributed the decline to both an increase in across the board emerging market risk and an increase in Indonesian sovereign risk. Other currencies in the region have suffered similar or worse declines, with the Korean won down 35% yoy, the Indian Rupee down over 20% yoy, and Philippine dollar down almost 11% yoy. The leading indicator of Indonesian sovereign risk, Indonesia's credit default spread over US Treasuries, rose to over 1200 basis points in recent trading, several hundred basis points above the Philippines and Vietnam. The swift move in the currency prompted the Government of Indonesia (GOI) to announce several measures to stem the decline in financial markets increase demand for the IDR, including a plan for the GOI and BI to purchase government bonds and a requirement for state-owned enterprises to deposit all foreign exchange in state-owned banks (septel).

¶4. (SBU) The risk of capital flight from foreign investors remains significant, but capital flight from domestic investors poses a much bigger risk to macroeconomic stability. The face value of foreign holdings of Indonesian government bonds is roughly $10 billion, according to the IMF resident representative. However, the market price of these assets has fallen significantly, reducing the probability and impact of foreign investors selling their holdings. Moreover, shorter-term investors such as hedge funds hold less than $16 billion of the total $54 billion of foreign investment in Indonesian equities, limiting the potential impact of foreign capital flight from the stock market, according to Joshua Tanja, a banking analyst with UBS Jakarta. Tanja notes that a decision by large domestic investors to move money out of the country poses a significant risk to the stability of Indonesia's currency and capital markets. To date, however, UBS Jakarta has not seen signs of significant movement of domestic wealth.

Commodity Price Reversal Threatens Exports, Growth
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¶5. (SBU) The recent reversal in commodity prices will slow Indonesia's export growth in coming months and may significantly slow overall growth in 2009. Rubber, coal and palm oil, which comprise 30% of Indonesia's exports, have fallen 10%, 17% and 33%, respectively from July to September 2008, and are expected to continue to decline. Indonesia recorded a trade deficit in July and a small surplus in August, compared to larger surpluses during most of the last two years. In addition to lowering overall economic growth, the weaker trade balance has put pressure on the currency, as currency traders worry that a potential trade deficit combined with capital flight will undermine Indonesia's balance of payments. Analysts expect demand for Indonesian commodities to continue to decline in line with the forecast for markedly lower world growth rates in 2008 and 2009. The GOI reduced the export tax on crude palm oil to zero in an attempt to offset the impact of declining prices.

¶6. (SBU) A number of analysts have also raised concerns about the level of leverage among commodity-based firms, given the sharp increase in borrowing over the past two years. The Indonesian corporate sector has undergone significant deleveraging since the financial crisis of 1997-98, with debt-to-equity ratios of listed firms falling from 180 to below 40 over the period 2001-2007. However, lending to the corporate sector, particularly the mining sector, expanded rapidly over the past two years. The year-on-year increase in bank lending rose from less than 10% in the third quarter of 2006 to 35% by July 2008. Lending to the mining sector rose 65% yoy as of August 2008. In addition, a Deutsche Bank representative in the region reported to the Embassy that some large Indonesian corporations borrowed USD from foreign banks using various interest-linked structured products to reduce borrowing costs in recent years. These products have since reversed direction and now significantly increase borrowing costs, according to the bankers. It remains unclear if this is a widespread problem or confined to a few firms.

Banking Sector Asset Quality May Deteriorate

¶7. (SBU) Banking sector analysts expect Indonesian bank exposure to the commodity sector to strain asset quality and liquidity, but the

scale of the problem is uncertain. Indonesian plantations and mining firms that over expanded during the commodities boom may face significant cash flow shortages in light of the commodity price reversal and limited access to new credit. According to Raihan Zamil, the IMF's resident adviser in BI's banking supervision department, there is very limited information available about the underwriting standards used for loans to the plantation and mining sectors during the boom. If the banks based these loans on assumptions of rising commodities prices, the banks may be facing a new wave of non-performing loans. Although Indonesia's largest banks are well capitalized and able to absorb an increase in nonperforming loans (NPLs), a rise in NPLs levels could further tighten liquidity conditions in the sector given the rising level of risk aversion associated with the global financial crisis.

¶8. (SBU) Indonesian banks are also facing a rapidly rising cost of funds that may strain earnings and slow loan growth considerably, further constraining growth in the real sector. Deposit growth rates have failed to keep pace with loan growth in 2008, and competition for deposits in the current environment has become fierce. Although the large banks have agreed to cap retail deposit rates at 13%, analyst reports indicate that banks are paying rates as high as 15% for large corporate deposits. The banks also hold a significant amount of government bonds, which have sharply declined in value in recent weeks and remain largely illiquid.

¶9. (SBU) The higher funding costs will squeeze net interest margins and likely impact access to credit for the corporate and consumer sectors. A growing number of analysts and business leaders have commented on the difficulty of securing USD denominated trade finance from local and foreign banks in Indonesia. Note: The GOI has recently announced plans to guarantee all local bank trade finance to ensure banks continue to extend to economically viable firms, but the details of the plan remain unclear. End note.] Deutsche Bank representatives suggest corporate debt rollovers are also becoming increasingly difficult to secure in Indonesia. Mortgage and motorcycle lending rates at many Indonesian banks have also increased, in some cases as much as 500 basis points, according to UBS' Tanja.

Limited Local Food Price Adjustments

¶10. (SBU) The sharp decline in commodity prices has failed to provide significant price benefits to Indonesia's poor. Lower world rice, wheat and soybean prices should eventually increase purchasing power among low-income Indonesian households who spend over 50% of their income on food. However, local food prices have been slow to adjust to declining world prices, according to local market data collected by the Foreign Agricultural Service. The local price of rice is down 3% from its peak in June 2008, but remains near historical highs. The price of wheat-based instant noodles has continued to rise steadily. Both local and imported soybean prices also remain near peak levels. While international prices may ease further as global demand continues to slow, continued depreciation of the IDR may offset the effect of lower international food prices in local markets.

Political Pressure on Economic Team Increases

¶11. (SBU) Analysts worry that growing political pressure to ease monetary policy and lower subsidized fuel prices will undermine investor confidence, further destabilizing the IDR and spurring inflation. On October 27, Senior Deputy Governor of Bank Indonesia (BI), Miranda Goeltom, stated BI plans to shift its focus to addressing risks to economic growth, which now clearly outweigh the risk of inflation. Local press reports indicate that BI had already faced considerable political pressure not to raise rates on October
¶7. A reduction in interest rates in the current environment may contribute to additional capital outflows and further undermine the value of the IDR.

¶12. (SBU) At the same time, the sharp fall in global oil prices has prompted calls from politicians to lower the price of subsidized fuel. The GOI increased the subsidized fuel price by almost 29% in

May to ease pressure on the GOI's budget, as world oil prices rose to over $140 a barrel. A reduction in subsidized fuel prices, which would increase the GOI's subsidy bill and financing requirements, would heighten concerns about fiscal sustainability at a time when Indonesia's sovereign risk is already on the rise.

HUME